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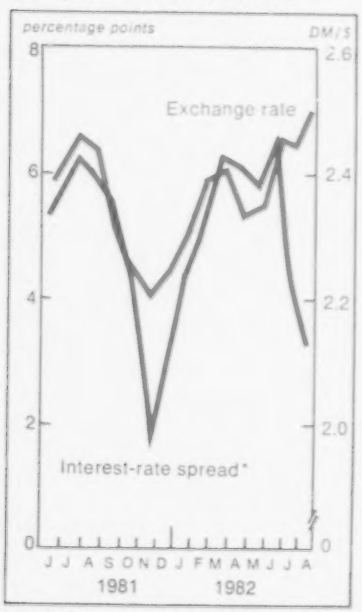
The Dollar's Surprising Strength

The dollar has remained surprisingly strong over the past two months in spite of the rapid narrowing of the spread between short-term interest rates on dollar-denominated assets and assets denominated in other currencies. Since the end of June, three-month Eurodollar rates have fallen roughly 400 basis points. Three-month EuroDM rates have fallen much less over that period—slightly more than 100 basis points—while Euroyen rates have actually risen. Even so, the dollar is now trading at about the same level against the mark and yen as it was two months ago. For the first time in 18 months a significant movement in interest rate differentials has not signalled a sharp movement in the trading range for the dollar.

U.S.-German interest-rate differentials and the DM price of the dollar



*3-month Eurodollar rate minus 3-month EuroDM rate, end of month

There is no fully satisfactory explanation for this development. Part of the answer appears to lie in the increased level of uncertainty in financial markets around the world. This summer has witnessed a steady progression of unsettling events. And the result has been something of a flight to assets considered relatively secure—U.S. government debt, gold, and the dollar. It is a measure of the market's confidence in the Federal Reserve's post-1979 commitment to controlling inflation that the dollar should once again have become a "haven currency." In the great bear market for the dollar in 1978-79, unexpected events tended to result in a dollar selloff.

Another reason for the continued dollar support is the perception that this marked narrowing of interest-rate spreads is likely to prove temporary. Foreign monetary authorities appear to be eager to adopt less restrictive policies, and many in the market believe that accelerated money growth—in large part the result of the recent decline in interest rates—will lead to a significant back up in U.S. rates this fall. Indeed, the desire to avoid a repetition of the events of last December, when an abrupt turnaround in U.S. money markets caught foreign policymakers by surprise and the dollar sharply appreciated, would appear to be a major force behind the cautious response of the Bundesbank to the recent fall in U.S. interest rates. The behavior of the exchange markets over the past two weeks suggests that this concern is not misplaced. Since the resolution of the short-term liquidity problems of many developing countries is likely to be some time away, firmed expectations of higher U.S. interest rates could easily lead to another episode of dollar strength.

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A French budget that should help calm foreign exchange market fears.

The French government's budget proposals for 1983 provide the first evidence to date of a shift in economic policy. The deficit is to be held, as promised, to no more than 3% of GDP or FF 118 billion—a level similar to this year's budget gap. Government plans to keep spending in check by allowing only a 12% increase in nominal terms over levels planned in 1982 proposals. The overall tax burden is not to increase, but it will weigh somewhat heavier on the higher paid taxpayers. The budget's underlying economic assumptions appear a little optimistic compared with private forecasts: real GDP growth of 1.7% this year followed by 2% in 1983, and a sharp drop in inflation from an average 12.3% this year to 8.3% next year. But even if the economy does not respond as well as is hoped, the government apparently plans to stick to a tight policy when the wage-price freeze expires in October, as evidenced, in part, by an official forecast that real personal disposable incomes will rise by only 0.9% in 1983. The foreign exchange market will still wish to see what results from the current wrangling over the wage guidelines that will go into effect after October 31. Nevertheless, the budget proposals should help to assuage fears of an imminent devaluation of the franc.

Finnish government resists pressures for reflationary budget.

The coalition government of Finland is now in the process of putting together its budget for 1983. The budget has not been easy to formulate because Finland's economic growth rate has been steadily falling for some time; 1982 will see virtual stagnation. However, the slowdown represents a normal business cycle brought on both by OECD sluggishness and by a leveling off in export demand from the Soviet Union. With this in mind, the government has resisted calls for widespread reflation and is putting together a budget designed to reduce inflation and to maintain international competitiveness. Inflation will probably average some 9.5% this year but is expected to fall further in 1983. The current account of the balance of payments showed a 482-million-markka surplus in the first half of this year while the year as a whole should see a surplus close to 1 billion markkaa. If exports pick up a little next year as is hoped, the balance of payments should improve further, and GDP should also show more buoyancy.

Knotty economic problems in store for winner of upcoming Swedish elections.

Sweden is now in the midst of campaigning for what is likely to be a close-run general election, scheduled for September 19. Sweden's economy has improved over the last year or so, and 1982's GDP will be about 1% up on 1981's recession level, while inflation will average 8.6% after 12.1% in 1981. The balance of trade will also improve considerably over last year's performance, although increased interest payments on the country's debt will prevent this improvement from being reflected in the current-account balance. However, whoever is elected to form the government will nevertheless face serious economic problems: Manufacturing output is still lower than it was in 1973, the export industries' share of foreign trade has been declining steadily, unemployment is rising, and total public expenditure accounts for almost two-thirds of GDP. As a result, reasonably tough policies can be expected over the next few years—regardless of the outcome of the upcoming election.

Panamanian public spending slows—and so does the economy.

Panama's economic momentum is slowing this year as a result of public-sector spending restraints and a decline in exports to other Latin American countries. Construction and agriculture have also been sluggish, while international banking and related services activities have held up well. Nevertheless, the recessive forces are likely to overpower the buoyancy of Panama's international financial sector enough to push real GDP growth down to 1.5%-2% this year, below the 3.6% of 1981. A more positive development—partly owing to the slowdown, but also the result of declining import prices—has been a drop in inflation to a low 4% annual rate in May. The Panamanian government's restrictive fiscal position is expected to continue in accordance with an IMF standby program which includes ceilings on public-sector deficits and national bank credit to non-financial governmental agencies. One key government goal is to limit the increase of external debt this year within the IMF targets.

Mexico enacts bank nationalization and exchange controls.

The nationalization of private bank deposits and the imposition of exchange controls are the latest actions taken by the Mexican government in a long series of events since a debt refinancing was announced on August 20. These measures represent efforts to halt capital outflow and help the country service its external debt. In addition, the government has requested a 90-day deferral of all public-sector principal payments, and a massive international support program has been launched. About $9.4 billion of actual or proposed credits are included in the Mexican assistance program from a group comprising the U.S. government, central banks of industrial countries, the IMF, and foreign commercial banks. The steps toward economic adjustment that will have to be undertaken to support the IMF and commercial bank credits are likely to mean further fiscal constraints and slower growth for the Mexican economy. Moreover, inflation pressures are also bound to intensify. A resolution of Mexico's external debt situation is going to take time, and it will require the steady adherence to stabilization measures on the part of the Mexican authorities.

India acts to boost exports.

Faced with a sizable current-account deficit, the Indian government has taken a number of steps in recent months to spur exports. The government has granted tax relief to companies that increase their export sales by more than 10% from the previous year. In addition, the authorities have expanded and simplified India's duty drawback scheme, under which excise and customs duties paid on inputs used in export production are refunded. To stimulate production in general and exports in particular, the government has liberalized its restrictions on industrial investment, allowing licensed firms to expand their authorized capacity by one-third above their highest production level in any of the previous five years. The government has also significantly eased import controls, particularly for industrial inputs, and exempted 100% export-oriented units totally from import licensing formalities. Despite these actions, exports this year still may fail to show much improvement because of the continued weakness of the world economy. However, over a longer period, these measures should have a significant impact on India's export capability and on its balance-of-payments performance.

Singapore slowdown reflects depressed world markets.

Singapore has at last begun to feel the effects of the world recession. The country's exports grew at a rate of only 6.6% in the second quarter of this year compared with an average of 25% per year between 1977 and 1980. The government has revised its estimate of 1982 real GDP growth downward by three percentage points, to between 5% and 7%, with the warning that even 5% may be unachievable if there is no economic recovery in the United States. This would represent a substantial slowdown from 9.9% real growth in 1981. Singapore officials have responded to these problems with a new program that includes the creation of a Trade Development Board to promote external trade. The private sector has advocated the establishment of such an organization for years, but the government has resisted. The reversal of policy reflects concerns that the current slump could last another 18 to 24 months.

Qatar's current-account surplus expected to decline.

The persistence of soft world demand for OPEC petroleum will shrink the current-account surplus of Qatar this year. In 1981, the surplus widened to $3 billion—despite a dip in gross oil revenues to $5.5 billion—as a 17% increase in Qatar's average oil price to $37 per barrel was slightly offset by a 14% drop in average oil output to 405,000 b/d. Still, the surplus grew, primarily because of a jump in non-oil income to $1.6 billion (mainly from foreign investments), but also because of a modest 4.3% expansion in imports and transfer payments to $3.9 billion. This year, however, Qatar's oil prices—assuming they hold steady through December—will average $34.60, down 6.5% from last year. Oil output is also down noticeably and could average around 350,000 b/d. If so, oil revenue would shrink by 20% to $4.25 billion and total exports to about $6.2 billion. Accordingly, even if payments for imports and transfers rise by a moderate 4.5% to $4.1 billion, Qatar would register a current-account surplus of no more than $2.1 billion.

Interest Rates and Economic Recovery

The unusually dramatic rally in the credit markets in the last two weeks of August capped a six-week slide in interest rates far sharper than had been generally forecast. The decline touched off a steep rise in the prices of gold and other commodities and one of the strongest stock market advances on record. Sustained strength in these markets would require a smart turnaround in the economy. However, such improvement may not be forthcoming soon.

In general, business plant and equipment spending, the desired level of inventories, and the pace of residential construction are directly affected by drastic changes in interest rates. If the recent drop in rates had occurred in a different economic environment, businesses could now be expected to be a bit more liberal in their capital spending and inventory decisions, and more households would be willing and able to buy new homes.

Given current conditions, however, the economy does not appear to be set for takeoff. Industrial production continued to decline during July—and probably August, as well—keeping capacity utilization below 70%. And end-of-summer retail sales have been relatively weak, considering the boost to personal disposable income from the July income-tax cut and increase in Social Security checks—perhaps in part because unemployment has continued to climb. In addition, mortgage rates are still high enough to restrain real estate activity. Consequently, despite the lower interest rates, neither businesses nor consumers have incentives to spend more freely at present.

Furthermore, expectations about future business conditions remain extremely uncertain, putting an added damper on economic activity, chiefly because of mixed signals on government policy. On the fiscal side, the recently enacted tax increase was passed with the intent of holding the fiscal 1983 deficit below $150 billion. But as the new fiscal year unfolds, it will become clear that the deficit will be considerably larger, embroiling Congress in more debates over further tax increases and spending cuts. With respect to monetary policy, the rapid decline in interest rates and somewhat faster growth in nominal demand have raised concerns about an acceleration in money growth and the probability of interest-rate increases in the fall.

Because of the prospects of a further back up in rates, the economy will be better off in the long run if businesses remain cautious a little longer. To become overly optimistic now and aggressively expand production to build up inventories to take advantage of the currently lower rates could backfire if the remaining uncertainties result in a spending shortfall. Excess inventories could lead to a new round of production cutbacks starting as early as this winter.

Douglas L. Beach

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF
		6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data
Algeria	Sharp increase in government outlays for housing projects planned.	May	—32%	36.0*	1,935	July
Egypt	Government's development outlays holding steady.	Feb.	—22%	22.7*	535	April
Ivory Coast	Oil exploration activity slows in anticipation of revenues from Espoir field beginning in 1983.	Nov.	—28%	9.8	1,190	May
Kenya	World Bank approves $136.9 million for continued structural adjustment and agricultural assistance.	March	— 5%	6.6	383	July
Malawi	Fiscal program for 1982/83 aims to increase private sector credit resources.	Feb.	—28%	1.5*	250	July
Mauritius	Austerity budget for fiscal 1982/83 provides for sales tax and restructured customs duties.	Dec.	—17%	6.5*	675	July
Morocco	Japan to lend 31 billion yen ($120 million) toward a sulphuric acid plant at Jorf Lasfar.	March	+ 3%	18.1*	896	June
Nigeria	Government borrows heavily for its development program.	May	—32%	86.8	1,125	June
Senegal	Recovery of agricultural production expected to return economy to positive growth rate this year.	n.a.	n.a.	2.5*	437	May
South Africa	Barclays National Bank enters mortgage market at below prime overdraft rate.	June	—24%	78.4	2,601	July
Tunisia	Sixth five-year plan (1982-86) approved; projects $13.5 billion investment, 6% average annual GNP growth.	Dec.	+ 6%	8.1	1,240	June
Zaire	Widespread shortages account for production capacity utilization remaining around 30%.	Dec.	—60%	5.8*	205	June
Zimbabwe	Weak export demand and drought-reduced maize and cotton crops slow economic growth.	Dec.	—15%	6.7	870	Dec.
Jordan	New income-tax law aims to boost revenues via higher personal tax ceilings, tighter enforcement.	Dec.	+ 29%	3.6*	1,127	June
Kuwait	Measures to deal with stock market malaise include recent formation of check clearing house.	May	—30%	24.3	17,350	May
Qatar	Government studying development of the huge North Dome gas field.	May	—33%	5.0*	23,000	Sept.'81
Saudi Arabia	Domestic oil and gas consumption officially projected to rise three-fold by 1990.	May	—22%	117.6*	14,050	July
United Arab Emirates	Official projects fiscal 1982 federal budget deficit of $1.1 billion—nearly double previous estimates.	May	—21%	29.8	29,780	July

BALANCE OF				
reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars
2,666	— 20%	3.5	0
705	— 20%	0.8	76
5	— 61%	0.0	431
202	— 32%	1.2	350
30	— 68%	1.1	70
23	— 61%	0.5	148
313	+ 154%	1.1	724
1,321	— 85%	1.4	0
6	— 5%	0.1	162
735	+ 8%	0.4	0
522	+ 8%	1.7	21
119	+ 88%	2.1	423
230	— 3%	2.0	40
1,007	— 18%	4.2	0
4,170	+ 7%	6.4	0
347	— 10%	2.3	0
30,635	+ 10%	11.0	0
2,967	+ 13%	3.9	0

Africa

Middle East

*1980

BEST AVAIL

Faster Money Growth Points to Higher Rates

Over the past few weeks most money market rates have backed up by more than 100 basis points in response to the August reacceleration of M1 growth above its upper target bound. Recent money supply data suggest that the Federal Reserve has apparently eased its monetary stance in response to political pressures to bring rates down. The result, however, is likely to be just the opposite.

Proponents of an easier stance contend that an acceleration in the growth rate of the money stock causes interest rates to fall. However, the evidence indicates that heightened money growth in fact tends to hasten interest rates by virtue of its direct positive effect on nominal income as well as an "inflation expectations" effect, which becomes operative when accelerated money growth creates expectations of rising prices in the future. The market builds an inflation premium into the level of interest rates to hedge against declines in the real value of investments.

The misconception that easier money will bring down rates stems from a blurring of the distinction between money and credit. Supporters of this view argue in effect, that interest rates are the equilibrating force behind the supply of and demand for money; rates must fall to induce people to hold increasing amounts of money. However, it is not interest rates but incomes that equilibrate money supply and demand; interest rates instead drive the market for credit.

The confusion arises because there is a first-round or "liquidity effect" arising as a byproduct of the money creation process when monetary expansion places downward pressure on rates. This occurs as the Fed boosts the credit base by injecting reserves through open-market operations. When the Fed increases its purchases of securities, the supply of loanable funds rises as banks expand their loan portfolios. The effect disappears, however, as soon as demand increases.

Moreover, recent evidence indicates that this liquidity effect may be exceedingly short-lived, in part because of the Fed's own operating procedures. Weekly movements in the money supply relative to targets often cause rates to move in the same direction, as the market anticipates a change in the Fed's stance in the credit markets, since the Fed's usage of lagged reserve accounting means the relevant level of required reserves is determined by the level of deposits two weeks earlier. A "passive tightening" occurs if the money supply accelerates. Net borrowed reserves increase, putting upward pressure on short-term rates unless reserves are injected to support the high level of required reserves.

The Fed successfully brought rates down earlier in the summer—but in an environment of weak money growth. In the spring of 1980 the Fed pumped in reserves to drive rates down only to find them skyrocketing in the wake of a monetary explosion. To again allow excessive money growth can only have the same result.

Robert S. Smith

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
rs	current influences on payments	latest data	consumer prices	latest data	money supply (M1)	September 8, 1982		current monetary conditions	
	Agreements reached on higher prices for Algerian gas.	Dec. '80	+10%	Nov.	+18%	.2200	-3%	France to lend $144 million for urban development.	Algeria
	Suez Canal revenue officially projected to rise to $1.25 billion by 1983.	Feb.	+12%	April	+33%	1.2200	-1%	Capital requirements of foreign banks may be raised.	Egypt
	Export outlook worsens as coffee surplus threat foreshadows price weakness.	Feb.	-9%	March	-2%	.00287	-16%	Foreign exchange shortage severe.	Ivory Coast
	Export compensation scheme suspended; export incentives promised.	May	+22%	May	+11%	.1100	-11%	Liquidity situation very tight.	Kenya
	Restructuring sought for $72 mn. principal and interest owed banks in 1982.	March	+2%	May	-1%	1.1000	+3%	Foreign liabilities rise sharply.	Malawi
	Exports severely limited by reinstatement of U.S. sugar import quotas.	April	+14%	May	0	.0960	-15%	Domestic credit expansion stagnates.	Mauritius
	Phosphate rock was $42.50/ton in second quarter, down 5% from first.	March	+15%	Feb.	+15%	.1900	-1%	Domestic credit expanding steadily.	Morocco
	Nigeria and Ivory Coast grant each other most-favored-nation status.	Dec.	+17%	April	+4%	.6802	n.a.	Delayed foreign exchange payments starting to move.	Nigeria
	Rice imports of over 400,000 tons a year account for 10% of total.	Jan.	-7%	March	-29%	.00287	-16%	Credit expands vigorously.	Senegal
	Large foreign loan repayments exert pressure on international reserves.	June	+16%	May	-23%	.8780	-16%	Rates remain firm.	South Africa
	Offshore oil discovery made by a unit of Marathon Oil.	Dec.	+10%	April	+18%	1.6700	-16%	Joint investment bank formulating program with UAE.	Tunisia
	Foreign exchange shortage caused arrears to rise above $465 mn. at end-'81.	April	+31%	Feb.	+36%	.1800	-1%	Credit expansion to government fuels money growth.	Zaire
	Pressure mounts for devaluation of currency.	March	+13%	April	+6%	1.3250	-12%	Demand deposits on declining trend.	Zimbabwe
	Jordanians working abroad officially projected to rise to 303,000 by 1985.	April	+9%	Dec.	+21%	2.9500	-1%	Credit generally available.	Jordan
	Jan.-June oil output averaged 633,000 b/d—43% below same 1981 period.	Dec.	+8%	June	+63%	3.4950	-1%	Bank credit to private sector rising steadily.	Kuwait
	Average Jan.-June oil output 340,000 b/d—27% below same 1981 period.	n.a.	n.a.	Sept.'81	+17%	.2780	-1%	Money supply growth rate slows.	Qatar
	Aramco Jan.-June output averaged 7.1 million b/d—29% below year earlier.	Jan.	-1%	Sept.'81	+17%	.2910	-1%	Riyal weakened relative to the dollar in July.	Saudi Arabia
	Abu Dhabi's Jan.-June oil output was 899,000 b/d—24% below year ago.	n.a.	n.a.	April	+19%	.2730	0	Money supply growing more slowly.	United Arab Emirates

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World Interest Rates

market rates as of Sept. 8, 1982; bond yields as of Sept. 3, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	13.74	10.625 intervention rate	13.00	9.50	7.00	18.00 penalty rate 21.00	7.00	5.00	5.50
Day-to-Day Money	9.75 September 9	15.50	11.125	11.50	14.125	8.00	18.75	7.625	2.25 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	8.23	13.50	10.00	13.50	n. a.	n. a.	16.60 79 days	no dealing	no market	5.625 two month
Commercial Paper prime, 3-month, asked	10.25 finance paper discount basis	14.00 finance paper 15% tax w/h	10.011	12.90 Certified	14.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.80	13.85 15% tax w/h	10.063	12.90 Certified	not traded	8.50	20.10	no market	4.00	no market
Government Bonds Long-term, new and old issues, average yield	12.16	14.35	11.03	9.958 20% tax w/h	15.46	8.75	19.11	6.94	4.64	8.112
Industrial Bonds prime, long-term, new and old issues, average yield	14.35 Aa Industrials	15.25	12.55	14.628	16.32	8.77	19.75	10.88	6.03	6.64
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	15.50	11.50	16.75	16.05	11.50	20.75 ⅛ qtrly fee on outstdng.	9.50	8.50	6.00
Bank Time Deposits 3-month	10.25 Cert. of Dep.	13.00	10.625	13.25	14.125	8.05	11.50	8.25 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	11.50	14.25	10.875	no market	21.00	7.875	no market	7.8125	3.8125	7.4375
Exchange Rates—in U.S.$ rates floating against the $	—	.8117	1.7240	.0210	.1418	.4024	.000715	.3673	.4723	.003866
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.50 *D*	1.00 *D*	1.00 *D*	9.00 *D*	3.50 *P*	9.50 *D*	3.50 *P*	7.50 *P*	4.00 *P*

Eurodollar Deposits
(London, interbank, bid)

September 9	
7-day	10.313
1-month	10.813
3-month	11.438
6-month	12.438

International Arbitrage
(3-month, hedged) ✣ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.633
U.S.-Canada Treasury Bills	−2.151
U.S.-Canada Finance Co. Paper	−1.058
Eurodollars-U.K. Local Auth. Deposits	+1.688

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.625
Over 7 yrs.	14.00
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.00

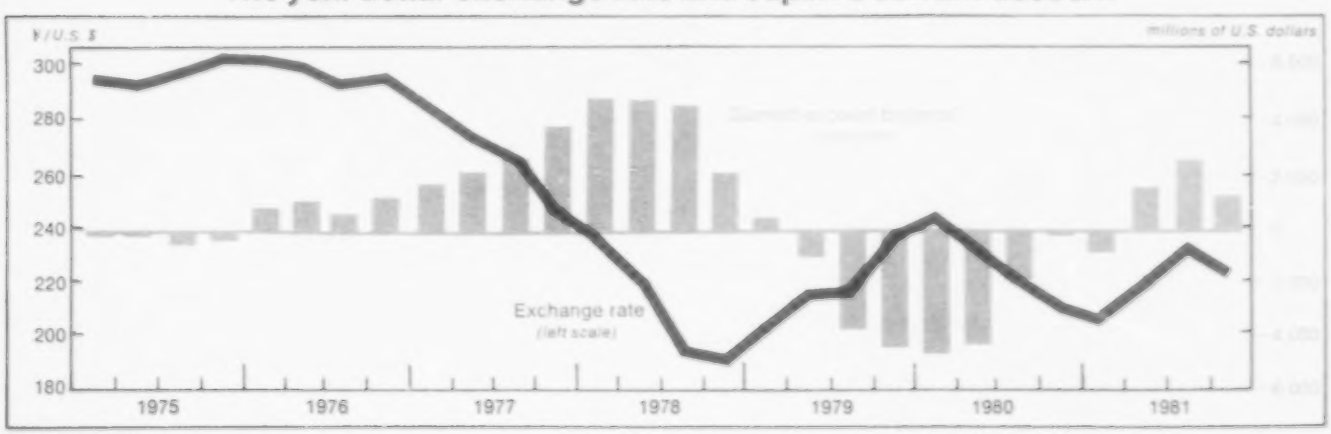
Gold Price

London afternoon fixing

461.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

The yen/dollar exchange rate and Japan's current account



*Seasonally adjusted

Japan's Changing Financial Markets

(Second of a three-part series)

Since the early 1970s, the Japanese financial system has undergone substantial structural changes in response to a number of internal and external developments. These changes, combined with the liberalization of Japan's foreign trade and exchange laws, have had far-reaching effects on both Japanese monetary policy and the behavior of the yen.

As noted in the first article of this series, during the early post-war period the Bank of Japan (BOJ) was able to control the domestic money supply by directly regulating credit to the private sector, since budget deficits and hence credit expansion to the government were relatively minor and since strict foreign exchange regulations kept changes in net foreign assets under control. The "dollar crisis" of the early 1970s, however, led to an enormous inflow of international reserves. And with the BOJ largely unable to offset the effects on the domestic money supply because of its limited open market operations, money growth soared and inflation accelerated. In February 1973, the government of Japan finally abandoned its fixed exchange rate system and adopted a managed floating exchange rate regime in order to be able to control the effect of reserve flows on the domestic money stock.

The first oil shock of 1973-74 also had a profound effect on the Japanese financial system. The growth of Japanese industry slowed dramatically as firms adjusted to the steep jump in oil prices. Consequently, business' strong demand for funds for investment subsided. Moreover, companies were increasingly able to generate needed funds internally, reducing their dependence on the banks for financing.

As the demand for funds by the corporate sector waned, the demand for funds by the public sector mushroomed. Government deficits began to rise sharply in fiscal 1975, as policymakers attempted to spur growth through increased spending—mainly for public works. To finance the deficits, the government issued large quantities of bonds. To a large extent, these were forced on the banks at below-market yields in order to control debt financing costs. As a result, the contribution made to the domestic money supply by net credit expansion to the government soared.

With banks less dependent on the BOJ for funds, firms less dependent on the banks for financing, and net credit to the government contributing more and more to increases in the domestic money supply, the central bank was no longer able to control the domestic money stock through direct controls on credit to the private sector. As a result, the BOJ shifted in the mid 1970s to a money-supply target and began to use open market operations as its primary tool of monetary policy. At the same time, the monetary authorities took steps to increase the use of interest rates to regulate the quantity of funds supplied and demanded.

The new foreign exchange law

Perhaps the most significant developments recently in the Japanese financial system have resulted from the New Foreign Exchange and Foreign Trade Control Law, which went into effect on December 1, 1980. Although great strides had been made in liberalizing exchange controls prior to the new law, all overseas transactions still were prohibited in principle and required official approval. According to the new law, however, all external transactions in trade, foreign exchange, and capital are now technically free, unless specified otherwise. Four types of transactions that had not been fully liberalized previously are affected:

- Japanese residents now have unlimited freedom to change yen into foreign currency for deposit with Japanese foreign exchange banks, whereas previously there had been a ¥3 million limit;
- Japanese banks are now free to borrow and lend foreign currencies at home and abroad without restrictions—at least in principle;
- Japanese companies have greater freedom to borrow abroad; and
- The scope for foreign investment in Japan has been widened, particularly in the area of equities.

Although, in essence, all international transactions are free under the new law, the monetary authorities do continue to exert some control through administrative guidance. For example, the monetary authorities limit "samurai" bond issues (yen-denominated bonds floated by foreigners) as well as banks' yen-denominated and foreign-currency syndicated loans. The monetary authorities have also reserved the right under the law to impose formal restrictions in case of an emergency, such as excessive exchange rate fluctuations, balance of payments deficits, or massive capital movements that adversely affect the money markets.

This liberalization of capital flows has important implications both for the structure of the Japanese financial system and for the conduct of monetary policy in Japan. By increasing the menu of financial assets available to the Japanese investor, the new foreign exchange law is likely to contribute significantly to the liberalization of Japanese interest rates. Specifically, the decontrol of domestic deposit rates may be hastened, since interest rates on yen deposits are still controlled by law, while rates on foreign currency deposits are allowed to fluctuate in line with prevailing Eurodollar rates. In addition, by opening up addi-

Japan's Changing Financial Markets *(continued from page 7)*

tional avenues for the banks and firms to raise funds, the new law further reduces the dependence of firms on the banks and the dependence of the banks on the BOJ. This then dampens the effectiveness of the traditional tools of monetary policy even more. Window guidance, in particular, is now much less effective in times of monetary restraint, since firms can circumvent the lending ceilings by borrowing abroad.

Furthermore, the lifting of capital controls has resulted in interest-rate arbitrage between domestic and foreign securities. As a consequence, Japanese capital flows have become quite sensitive to changes in interest-rate differentials and to changes in exchange rate expectations. Thus, the Japanese monetary authorities are finding it increasingly difficult to control domestic interest rates and to insulate the domestic economy from foreign developments. This has been particularly evident over the last year as high real interest rates in the United States have put upward pressure on rates in Japan. Moreover, by opening up an additional avenue through which an excess supply or demand for money can be dissipated, the relaxation of capital controls has also made it harder for the BOJ to control the domestic money supply, to the extent that the exchange rate is not freely floating. To exert some influence in such an environment, the BOJ must allow its policy changes to be reflected in interest rates.

The new discount mechanism announced in March 1981 seemed to be a signal that the Japanese monetary authorities increasingly would use interest rates, rather than quantitative controls, to affect capital flows. Under the new system, central bank loans to banks are to be made at a rate higher than the discount rate when the BOJ wants to induce an increase in domestic interest rates in order to stem an outflow of capital. The new system has yet to be used, however, and earlier this year, the Japanese authorities reverted to direct controls to moderate capital flows because of the weakness of the yen.

Implications for the yen

Provided that the Japanese monetary authorities do not intervene more extensively to control capital flows, the liberalization of capital flows also has important implications for the behavior of the yen. Until 1979, the behavior of the yen/dollar exchange rate mirrored closely the behavior of the current account (see chart on page 6); in general, the yen appreciated as the current account improved and depreciated as the current account deteriorated. Because capital movements were closely controlled by the monetary authorities, the current account was virtually the only avenue through which stock disequilibrium in the money market could be eliminated—other than through changes in the domestic price level or real output. For example, an excess supply of money in the economy could be dissipated through increased purchases of domestic goods—causing an increase in either real output or the domestic price level—or through increased purchases of foreign goods. The latter would cause a deterioration in the current account and, depending on the degree to which the monetary authorities intervened, a loss of reserves or depreciation of the exchange rate. Thus, although the exchange rate was influenced by monetary phenomena, it closely mirrored the behavior of the current account, since both reflected the same stock disequilibrium in the money market. The extent to which this disequilibrium was actually eliminated through the current account was dependent, of course, on the degree to which Japan's goods and services markets were relatively open—a topic still widely debated.

With the liberalization of capital flows under the new foreign exchange law, however, stock disequilibrium in the money market can now be eliminated through a combination of current- *and capital-account* adjustments. As a result, there need not be any particular relationship between changes in the current account balance and changes in the exchange rate, since monetary phenomena can now be reflected in the capital account. Instead, the overall balance—that is, the change in reserves—and changes in the exchange rate will be related, because both reflect an excess demand or supply of money. For example, an excess supply of money in the economy can be dissipated through the domestic channel, as mentioned earlier, or through increased purchases of foreign goods *and securities*. This will cause a deterioration in the overall balance (sum of current and capital accounts) and, depending on the degree to which the monetary authorities intervene, a loss of reserves or depreciation of the exchange rate.

Presumably there is still likely to be a reasonably high correlation between changes in the current account balance and changes in the exchange rate, since stock disequilibrium in the money market is likely to be reflected in purchases of foreign goods as well as securities. But economists who base their forecasts of the yen on the outlook for the current account could be misled. As a case in point, in 1981 the rate of growth in broad money, at 11 percent, was far in excess of the growth in nominal income of 5.8 percent, suggesting that there was likely to be an excess supply of money in the economy. Yet despite a sharp improvement in the current account—from a deficit of $10.7 billion in 1980 to a surplus of $4.7 billion in 1981—the yen remained very weak, averaging 220.53 yen per dollar in 1981 against 226.75 in 1980. This was because the excess supply of money was dissipated largely through the capital account.

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